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December 18, 2007

AGENDA ITEM 5a

TO: MEMBERS OF THE HEALTH BENEFITS COMMITTEE

- I. SUBJECT:** Health Maintenance Organization Financial Reserves Report
- II. PROGRAM:** Health Benefits
- III. RECOMMENDATION:** Information Only
- IV. ANALYSIS:**

Introduction

At the November 14, 2007, Health Benefits Committee (HBC) meeting it was requested that the contracting Health Maintenance Organizations (HMO) present at the December 18, 2007, HBC meeting information regarding their financial reserves. This report is to provide the HBC with an overview of the financial reserves for both the Blue Shield of California HMO Plan and Kaiser Permanente relating to the CalPERS membership.

Background

California HMOs are held to a different accounting standard from CalPERS Self-Funded operations. The CalPERS Self-Funded operations are funds that are internal to CalPERS from which fees are paid to our contractors for the administrative and clinical services they perform. Additionally, CalPERS directly pays the claims of providers from these funds. This is different from HMOs in that CalPERS Self-Funded operations exists and operates only for CalPERS. The source of its funds is from CalPERS and the reserves are held by CalPERS for the benefit of the Self-Funded operations and CalPERS members.

The CalPERS contracting HMOs are separate and distinct entities apart from CalPERS and as such come under the regulation of the Department of Managed Health Care (DMHC). In addition to exercising prudent business practices, HMOs are required to meet California regulatory requirements such as maintaining a minimum Tangible Net Equity (TNE) as determined under Section 1300.76 of Title 28, California Code of Regulations. In this case TNE is the minimum amount of "reserves" required by an HMO in order to maintain compliance with California's HMO licensing standards. The required amount of TNE is determined based on the amount and type of risk exposure. Another term used in this case would be "Risk Based Capital". Part of the risk that an HMO is exposed to is that of medical claims for services that have been provided for which a claim has yet to be received and the associated cost to adjudicate these claims. This is also known as "Incurred But Not Reported" (IBNR) claims. In addition to fulfilling the regulatory required TNE amounts, a well managed HMO will have additional "reserves" that represent the value of their internal infrastructure such as; office buildings, capital equipment, etc. Additionally, part of a reserve may be dedicated to some future business project such as computer conversions, the launch of new business products or some other type of long-term benefit project (member health investment activities).

Blue Shield of California

The financial position of the Access + HMO and the EPO plans remain strong. The medical and pharmacy claims twelve month cost trend continues to show close to expected trends for 2007. These financial results, plus adequate reserve levels, provide assurance that the rates approved by the Board for the 2007 plan year were sufficient to cover the cost of healthcare and administrative costs.

At Blue Shield, reserves for claims liabilities including IBNR claims and claims payable are computed and restated on a monthly basis. Reserves are computed at line of business level and by type of benefits for inpatient, outpatient, professional, ancillary, and pharmacy based on historical claim experience and payment patterns. These reserves are also examined in aggregate or more detail level when needed. In addition, reserves are also set for large outlier claims for high cost individuals. Reserves for CalPERS Access + HMO and EPO plans are computed using a methodology consistent with other Blue Shield clients.

Each month, reserve balances are reviewed by the Blue Shield Chief Actuary, Director of Reserves and his staff, and the business unit actuaries for reasonableness based on their knowledge of the business operations. The actuaries also review, among other things, inventory levels and business unit activities to make sure the reserve balances are aligned.

As the reserves are restated each month, any generated surpluses/deficits are rolled over to CalPERS on an annual basis as stipulated in the Blue Shield contract.

Overall, Blue Shield's reserves for the CalPERS line of business:

- are computed in accordance with commonly accepted actuarial standards, consistently applied, and fairly stated in accordance with sound actuarial principles;
- are based on actuarial assumptions which produce reserves at least as great as those called for in any policy or contract provision as to reserve basis and method, are in accordance with relevant policy or contract provisions, and are appropriate to the purpose for which the Statement was prepared;
- meet the requirements of the laws of the State of California;
- are computed on the basis of assumptions consistent with those used in computing the corresponding items in the annual statement of the preceding year-end.

In terms of audit, Blue Shield reserves are reviewed on an annual basis by external auditors (Deloitte & Touche) for reasonableness and accuracy. In accordance with the Blue Shield – CalPERS contract, the CalPERS reserves have also been audited twice, in 2004 and in 2006, by an independent third party actuarial firm and the reserves were found to be reasonable and accurate.

Blue Shield is financially strong as shown by ratings from the credit rating agencies. Its Risk Based Capital (RBC) level, as a measurement developed by the National Association of Insurance Commissioners (NAIC) to measure the minimum amount of capital that an insurance company needs to support its overall business operations, has been consistently above system-wide levels among all Blue plans.

In summary, Blue Shield uses industry standard methods to set and manage reserves. Based on historical comparisons of actual claims run-out to booked reserves, Blue Shield's reserving for CalPERS has been highly accurate. Independent reviews by external auditors have confirmed that Blue Shield's reserving is reasonable and accurate. Even if reserving is off in either direction, it has at most a minor and temporary effect on pricing due to the roll-over feature in the Blue Shield contract. A copy of Blue Shield's presentation may be found at Attachment 1.

Kaiser Permanente

Kaiser Health Plan's presentation will be presented orally based on the information found in Attachment 2.

V. STRATEGIC PLAN:

This directly relates to Goal X: Develop and administer quality, sustainable health benefit programs that are responsive to and valued by enrollees and employers.

VI. RESULTS/COSTS:

There is no cost associated with this item.

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Attachments